

## Internal Revenue Service

Department of the Treasury  
Washington, DC 20224

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**PLR-124105-06**

Date: April 25, 2007

Company =

State =

Shareholders =

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a =b =c =d =

Dear :

We received a letter dated April 21, 2006, submitted on behalf of Company, requesting rulings under § 1361(b)(1)(D) of the Internal Revenue Code. This letter responds to that request.

### FACTS

Company incorporated under the laws of State on a and elected to be an S corporation effective on that date. The Shareholders of Company acquired their interests at various times between a and c.

From b through c, Company inadvertently made shareholder distributions that were not in proportion to the Shareholders' respective stock ownership in Company. Company made distributions to some of the Shareholders of amounts equal to their anticipated tax liabilities. In addition, Company made distributions in the form of "cash advances" to some of the Shareholders; however, those "cash advances" did not qualify as straight debt for purposes of § 1361(c)(5).

Company represents that its management was unaware that disproportionate distributions could cause Company to have more than one class of stock. Company also represents that its original and amended articles of incorporation expressly authorize the issuance of only one class of stock by Company. In addition, under State law all shares of Company stock have had identical rights, preferences, privileges and restrictions, including identical rights to Company's distribution and liquidation proceeds, since Company's incorporation. Company further represents that State law requires pro rata distributions to all shareholders within a single class of stock and that Company's by-laws do not change these rights provided under State law. Finally, Company represents that there is no agreement or understanding (written or oral) that any shareholder would be entitled to a preference regarding Company's distribution or liquidation proceeds.

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After learning of the potential termination of Company's S corporation election, Company made initial corrective distributions to some of the Shareholders on or about d. In addition, Company plans to make such additional corrective distributions to or receive payments due from some of the Shareholders that Company has determined are necessary. Finally, Company and the Shareholders have agreed to make any further adjustments (consistent with the treatment of Company as an S corporation) as may be required by the Secretary.

#### LAW

Section 1361(a)(1) provides that for purposes of title 1, the term "S corporation" means, with respect to the taxable year, a small business corporation for which an election under § 1362(a) is in effect for the year.

Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not-- (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that a corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in § 1.1361-1(l)(4) (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

Section 1.1361-1(l)(2)(i) provides that the determination whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

In § 1.1361-1(l)(2)(vi), Example 2, (Distributions that differ in timing), S, a corporation, has two equal shareholders, A and B. Under S's bylaws, A and B are entitled to equal distributions. S distributes \$50,000 to A in the current year, but does

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not distribute \$50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds. The example concludes that under § 1.1361-1(l)(2)(i), the difference in timing of the distributions to A and B does not cause S to be treated as having more than one class of stock. However, § 7872 or other recharacterization principles may apply to determine the appropriate tax consequences.

### CONCLUSION

Based on the facts and representations submitted by Company, we conclude that because Company's stock has identical distribution and liquidation rights under its governing provisions, the difference in timing between Company's disproportionate distributions to some of the Shareholders and Company's corrective distributions to or repayments from certain Shareholders do not cause Company to have more than one class of stock for purposes of § 1361(b)(1)(D). However, such disproportionate and corrective distributions must be given appropriate tax effect. Under these circumstances, we conclude that Company's S corporation election did not terminate because of the disproportionate and corrective distributions to the Shareholders.

Except for the specific ruling above, we express or imply no opinion concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding Company's eligibility to be an S corporation.

Under a power of attorney on file with this office, we are sending a copy of this letter to Company's authorized representative.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

/s/

CHRISTINE ELLISON  
Chief, Branch 3  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure: copy of this letter for § 6110 purposes